RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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July 18, 1979 **LETTER 761**

July 6, DJIA 846.16; PTI 1051; A-D Ratio –18.03
July 13, DJIA 833.53; PTI 1040; A-D Ratio –18.84

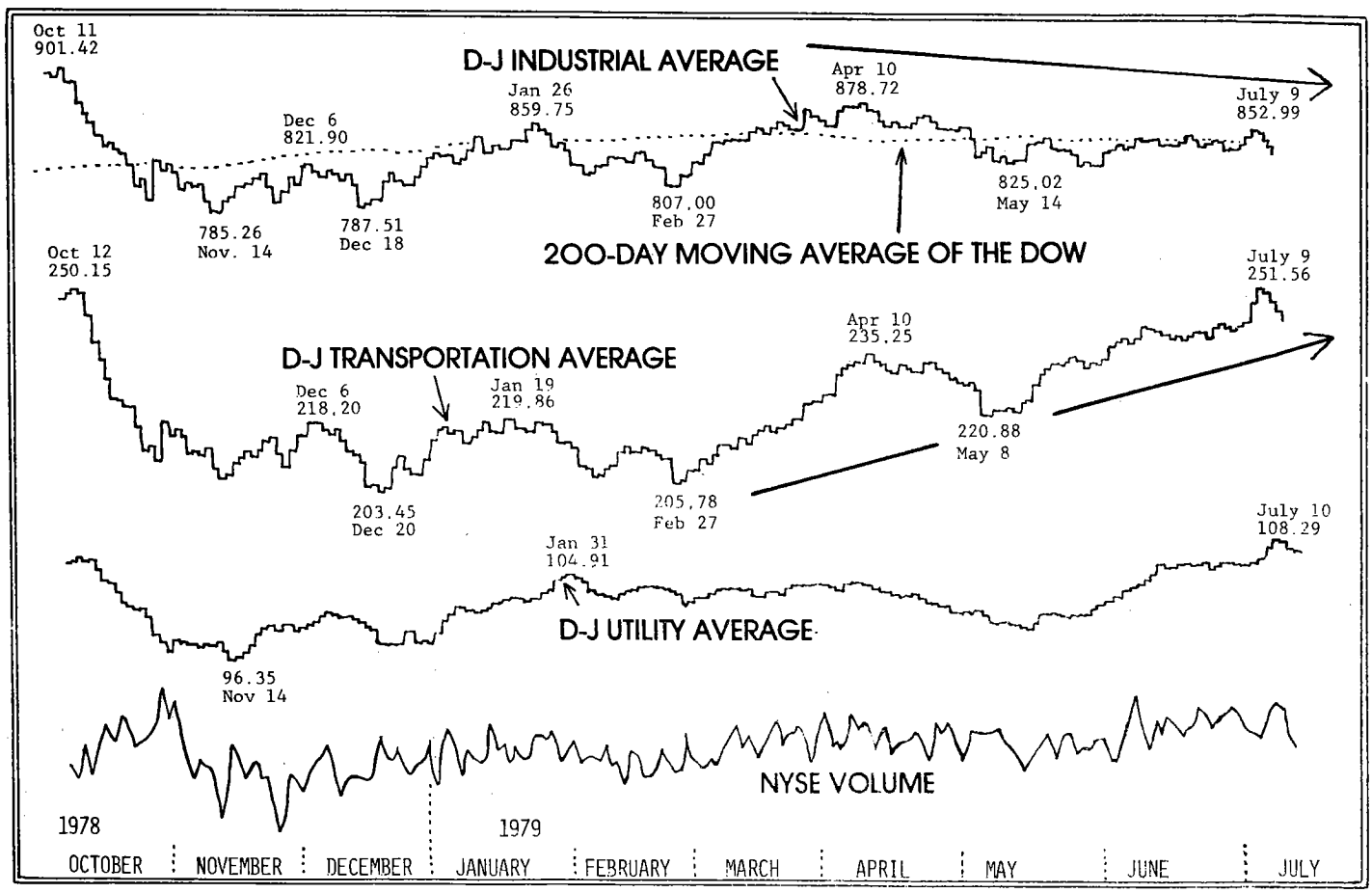
THE PICTURE: July (a month I felt would be fateful) is half over, and it finds the Dow still holding within its great 4 year triangle (although a Dow below 820 would shatter the triangle). Washington, as usual, is part perplexed, part paralyzed. Gold hangs about the 290 (record high) level, but gold momentum is ebbing. Inflation continues rampant. The "coming recession" gets nationwide billing, with even the Carter Administration now advertising it. The President's popularity hits historic lows (actually below Nixon's). Auto sales slump. And people speculate *ad nauseum* on whether Teddy Kennedy will or will not run.

The stock market (up to last week) seemed all but immune to shock. But the fact is that the Dow has been locked into a tight range between the November low of 785.26 and the April high of 878.72 (a 93 point or 10% band) for the past 9 months. How long can the senior Average fluctuate in "no man's land"? Obviously, as long as it wants, but I'd be amazed if we can get through the next 6 months with the Dow still holding within this same trading range.

Four items of interest concern me this week. First, the money market instruments (bills, bonds, Ginnies, etc.) appear to have built at least temporary tops. That means that interest rates are pushing up again. Last week we did see T-bill yields pop to 9.33, just .40 basis points below their previous 1979 highs (after breaking down to about an 8.8% yield basis. The free (free from Fed manipulation) Eurodollar 91-day bill rate is currently just under 11%. Europe is evidently not going to give in to inflation, and Britain and Germany have already boosted their rates (Japan has also raised its money rates).

On July 12 my negative volume index gave a major sell signal as the index broke to a new post-1974 low. This is the cumulative index of advance-decline differentials, but registered only on days when NYSE volume is below that of the preceding day. Major new lows on the negative volume index usually means that breadth is in major trouble. Or to put it another way, such signals imply that advances on rising volume are not sustained during declines on lower volume. For this reason, I would expect the A-D ratio to run into trouble from this point on.

The third item is the non-confirmation that still exists in the D-J Averages. The D-J Transportation Average is near its high for the year, but the Dow (stubborn devil that it is) is still far below its 878.72 comparable high. True, last week the Dow bettered its nearby peak of 849.10 (June 22), but that isn't enough. A true confirmation of a bull trend would entail a bettering of 878.72– and that just has not happened.



Doubters can say that the Averages "don't tell the whole story." How many times have I heard that before! Sure, the Averages don't tell us what's happening to every stock on the Big Board, but history tells us to ignore the Averages at our peril. At any rate, the page 1 chart displays the current non-confirmation, and those who want to excuse it away are free to do so.

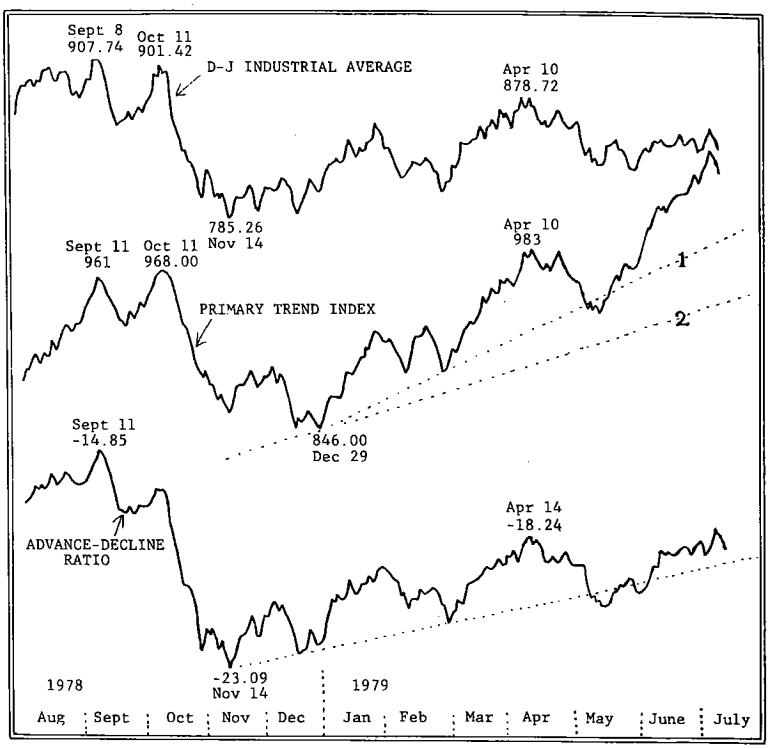
Finally, I mentioned in the last Letter that my momentum index of the Dow has turned **down**. Ned Davis of J. C. Bradford (Bradford Timing Letter, PO Box 2584, Arcade Sta., Nashville, Tenn. 37219) uses a smoothed momentum index which is even clearer than mine, and I show his chart here. Note that each Dow top has produced an A and a second or B peak. Following the A peak the Dow usually turned ragged, but a new high was usually seen. When the peak was established and the momentum index turned down–that was it. The Dow headed down with a vengeance.

On June 29, Ned's momentum index gave a sell signal as momentum turned down following the B peak. Two things particularly interested me about this sell signal. First, the Dow was unable to record a new high following the A peak, and this strikes me as a particularly weak performance on the part of the Dow. Second, the B peak came from the lowest level of any of the B or secondary signals shown on the chart. This again suggests weakness in the technical underpinnings of the Dow.

Note that the Dow has been tracing out a large symmetrical triangle. Based on past experience, I would think that a break out of this triangle should come with real force. A Dow rally to 880 would take the senior Average out of the triangle on the upside. A Dow break below 820 would take the Average below the triangle on the downside.

Since the last Letter two items of interest have graced the chart (top, right) of the Primary Trend Index and the A-D ratio. First, the PTI (an amalgam of 8 critical indices and averages) has risen to yet another new 1979 high. And as has been the case all year, the new PTI high was not confirmed by the Dow.

I have been repeating in each Letter that there is no way that this market can "fall apart" unless the PTI heads down too.

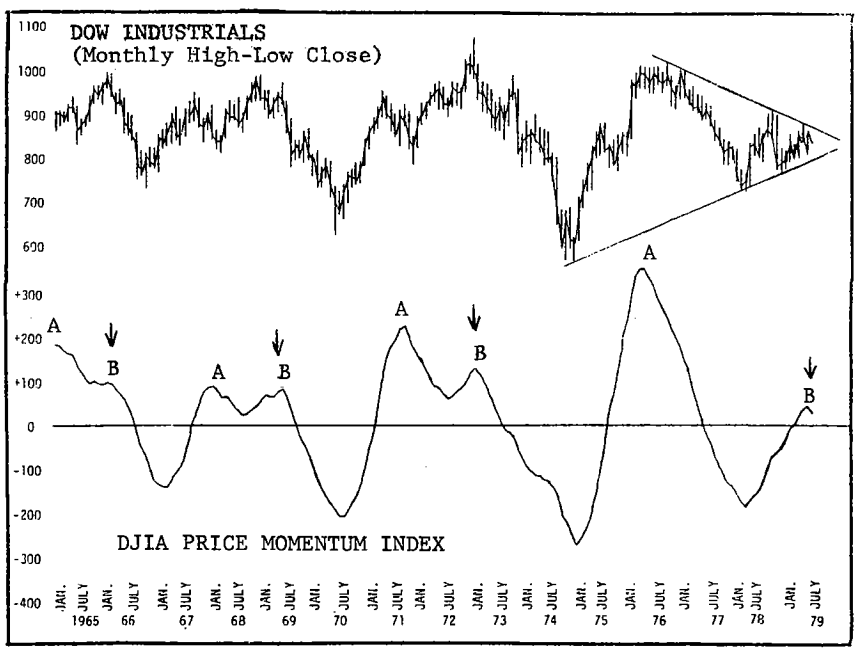


A rising PTI implies that the technical underpinnings are still intact (and bullish), and this has been the situation all year. Note the two trendlines which I have drawn under the PTI. The first important sign of technical deterioration would be a violation of trendline 1. A breaking of trendline 2 would spell "finish" to the whole rise. So far–no weakness in this picture, except for the technical problem of the non-confirming Dow.

The A-D ratio, still in its long, shallow advance, has bettered its April 14 peak. But instead of lighting a fire under the market, the new A-D high seemed to have signified little or nothing.

Conclusion: It's a standoff in a tricky and frustrating market. Read on for tactics.

SURVIVAL: In order to survive in the investment world, we have to deal with facts. I read about the best advisories and informational material obtainable. I talk weekly to some of the best minds in the money, stock, commodity and business world. In the end I have to make my own mind up about what is fact and what isn't. Here are some items which I feel we must ponder if we are to survive in today's investment world.



(1) The ratio of stocks to houses (historically) has swung heavily in favor of stocks (stocks are *relatively* too cheap while houses are *relatively* too expensive). The stock/house ratio has not been as low as it is now since 1949 (and previous to that in 1925).

(2) The world energy picture is a hodge-podge. OPEC is now in control of world oil prices, but I'm skeptical about any group controlling any market for long. My guess is that the US and many other nations are going to jump into alternate forms of energy ("synfuels" or synthetic fuels). In due time, this new production will put the skids on the oil market and fuel prices will tumble. Even now, with consumers cutting back and the Saudi's boosting their output, spot oil prices are breaking. My best

guess: somewhere in the future the US will be stuck with very high cost synfuel, and OPEC oil prices will hit the skids. The result–a costly energy fiasco (all brought on by the US's idiotic policy of "pleasing consumers" by artificially holding down the price of oil).

(3) The world debt structure is fantastically top-heavy. Debt is being "held up" (i.e. serviced) by more debt. Debt creation over the past four decades has been America's greatest growth business. Debt servicing is going to be an unbelievably difficult task during the next economic downturn. I'm convinced that nations will turn to ever-increasing debt pyramids to finance their debt loads during the next economic contraction. Note: already, American politicians are talking about a tax cut for 1980.

(4) There is no longer any single island of investment safety in the event of more inflation or even deflation. During periods of super-instability such as this one, the winner is the man who loses the least. Inflation wipes out purchasing power; deflation also wipes out purchasing power. Only stability allows for healthy growth. The odds for stability over the next few years are slim to zero. This has thrown most investors into a state of quiet panic. No one sees a clear path to retention of purchasing power.

(5) The US is overdue for a recession–as is the rest of the world. But no one is positive that a recession is actually on the way, and if so whether the next recession will be deep (even a depression) or shallow. Furthermore, the US Government (terrified of even worse deficits should a major recession hit) is currently doing everything it can to avoid recession–even to the point of making money freely available when all past experience indicates that money should be scarce and tight at this stage of the business cycle.

(6) To top off the list of problems, interest rates are still at historically high levels. But leading experts disagree as to the next major direction of rates. Some believe interest rates are topping, others believe we will see new highs. How does one operate in this kind of atmosphere?

(7) Because many of the markets have swung so widely in the past few years and because the competition for retention of purchasing power is so fierce, the concept of market timing has gained a very wide following. Everybody is doing it. Furthermore, everyone is now a contrarian. How can one go contrary to a consensus of contrarians? The contrary approach thus breaks down into absurdity.

(8) The alternative to market timing during an era of instability is–DIVERSIFICATION. The man who owns items in five or six different categories hopes to retain his purchasing power during any kind of market on the theory that as one category will rise another will decline. The net result (hopefully) is stability of value of total assets.

(9) The tabulations at right should be studied. →

Note: in 1932 Dow earnings practically disappeared (although many dividends held), which accounts for the high P/E ratio that year.

What we see above is most interesting. Today the Dow P/E ratio is low and attractive, the yield is fairly attractive, and the Dow is selling below book value and far below replacement costs. On almost all counts, the Dow would seem to be in the bargain area.

There is only one catch, and that catch was expressed in the last paragraph of the last Letter. The *negative* yield gap between stocks and bonds has now become chronic. I showed how $10,000 invested in Guardian Mutual Fund grew at an 11% compounded rate since 1950. But the catch is that many fixed-return securities now offer roughly 11% compound interest, and the risk is far less. What most people do not understand is that once you get over 9% interest, bonds provide vicious competition for stocks, stocks that yield only 4, 5, and 6%. At 9% money doubles in 8 years, at 10% money doubles in a little over 7 years, at 11% money doubles in just under 7 years.

Most well run institutional funds cannot produce a compound return of 11% over a 30 year period. Thus the very high yields now available on many bonds provide *unbelievably tough competition* for stocks and the Dow, even with the Dow selling at presumably bargain levels.

(10) Most investors now face a terrific problem. Gold is up. Blue chip stocks are down. Many speculative stocks are up. Home prices are up. Commodity prices are up, but commodity speculation is not for the average person. Interest rates are up. Bond prices are near historic lows. Bond yields are historically high. The stock market, battered by bad news, has been holding. But now a recession could be nearing. The stock market is far from over-sold, and a major bottom may appear during the next six months to a year. What do we do?

Following is the course I believe will stand us in good stead. I would hold 10% of assets in gold coins. Gold is a non-productive asset, since it returns no income, but it is a chaos hedge. The fact is that no one knows whether gold will ultimately go to 320 or 1000, or whether it is topping now. But if everything else goes, gold will stand alone as true money. In 100 years, of everything you own, the one item which I am convinced will still be of value will be your gold coins.

Houses are hardly in the bargain category today, and (on a comparative basis) it will cost you far less to rent than to buy. Yet a home is a *comfort* during inflationary times. I personally like owning my home, but that's an emotional (not an economic) preference. If you own your own home today I would say, "Hang on to it." It's part of your diversification program, and it's an asset you are not likely to be "shaken out of" (even if the housing market sags).

Real collectibles such as fine coins and stamps and antiques are part of a diversification program, but the majority of so-called "collectibles" tend to be of far less than investment-grade.

Important Bottoms for DJIA - Dates	P/E Ratios	Dow Dividend Yield	Dow Book Value	Premium or Discount	Bond Yield
July 8, 1932	60	15.8%	NA	NA	5.93%
April 28, 1942	9	8	102.66	.91	2.51
June 13, 1949	7	7.4	159.67	1.01	2.57
Oct. 22, 1957	11	5.4	284.78	1.47	3.97
Oct. 7, 1966	13	4.1	453.27	1.64	5.31
Dec. 6, 1974	6	6.6	690.23	.84	8.41
June 18, 1979	7	5.9	900 (est.)	.93	8.95

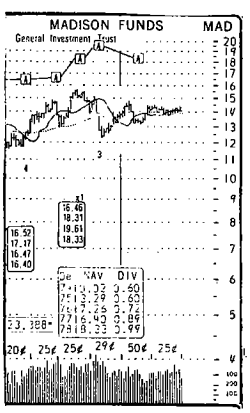
Unless you have a feel and a love for a certain category of collectibles, forget this item. If you don't buy expertly, you are probably flushing your money down the drain.

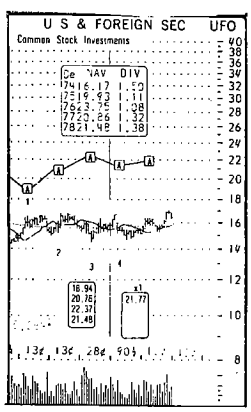
Income producing securities are at or near intrinsic bargain levels today. Various open-ended bond funds (no load) such as Northeast Investors (9.8% yield), Price New Income (9%), Vanguard Investment Trade (9%) provide good yields and literally instant liquidity. Many listed (NYSE) bond funds such as John Hancock Investors (9.6%) Intercapital (9.6%), Mutual of Omaha (10%), Transamerica Income (9.2%) provide good income and sell below their net assets. I think up to 20% of assets can be placed in three or more bond funds, either open-ended, closed-ended or both.

Finally, I believe (and I have given this much thought) that some of the closed end stock funds (listed on the NYSE) are now in a bargain area and well worth accumulating. Take the $420 million Madison Fund. At latest reading, this fund was selling at about 26% under its asset value. This well managed fund has 16% of its assets in energy, 11% in technology and is in the process of building up its natural resources portfolio. Its dividend yield is 5.9%, but capital gains are also distributed, so that total distributions in 1977 were .89, and in 1978 they were .99.

My feeling is that on the downside MAD should be resistant, mainly because of its large discount of 26% from net assets. But what if following some over-sold area, the market takes off and the Dow (see last Letter) heads for 1500 or 2000? At the 1968 high MAD sold for 35 or far ABOVE its net asset value of 25.65 that year. Thus, the discount leverage can work both ways. But today Madison's discount BELOW net assets is historically very large, and I think the current 26% discount reflects investor disenchantment with the stock market in general.

Another attractive closed-end fund is US and Foreign Securities (NYSE), selling at a 27% discount from net asset value. This fund has 21% of its assets in oil and gas with its largest holdings being Superior Oil, Amerada Hess pfd. and IBM. UFO paid out 1.51 in dividends and capital gains last year. Back at the 1968 high this stock sold at slightly above its net asset value of 44 (current price is 17).





A-boxes = Net asset value of fund.

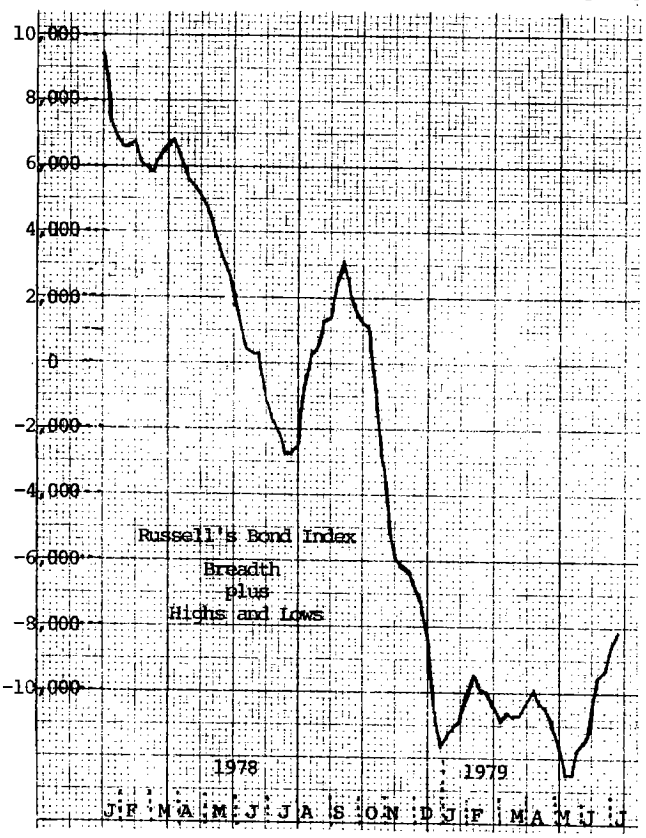
I believe that a careful policy of *accumulating* UFO and MAD over the next year will prove to be an intelligent part of any diversification program. Considering that the Dow is now selling for about 10% below its book value and UFO and MAD are in turn selling about 26% below their own net asset value, buying these shares would mean that you would be buying a portfolio of high-grade stocks at around one-third below book value. One of these days we will see a major market recovery, at which time UFO and MAD should not only move up with the market but will eliminate their discount spread. In the meantime, both funds pay attractive dividends plus capital gains.

To put it another way, if the Dow ever "takes off" on the upside there is going to be a big move into blue chip values and assets (in my considered opinion, since this has been the laggard part of the market and the sector of the market which is most undervalued). If that occurs, then I would expect the closed-end stock funds to start moving up, and I would expect the discounts on these funds to narrow considerably. On the other hand, if the market slides to 600 (Dow) from here, I would expect the closed-end funds to hold rather well. Finally, if the market does nothing, the closed-end funds will provide a high yield while we are waiting. (Chart courtesy of QUOTE, P.O. Box 213, Wichita, KA 67201).

BONDS: None of the bond averages or measurements have completely satisfied me, so a few years ago I invented my own bond gauge. Each weekend I add up all the daily bond advances and new bond highs for the preceding 5 days. From this total I subtract all the daily bond declines and new bond lows for the preceding 5 days (figures from the Wall Street Journal, and these statistics pertain only to NYSE listed bonds). The resultant A-D line plus high-lows appears on this weekly chart. What we see here is a chart that traces the broad action of the bond market.

The huge 1978-79 collapse shows as a drop from plus 10,000 to minus 12,400 on the chart. From the May 1979 low, bonds rallied for 7 consecutive weeks, moving my index up better than 4,400. In 1978 an upward correction carried for 8 weeks and moved the index up almost 6,000. Thus, the 1979 rally could be just another bear market (upward) correction as was the case in 1978—or it could represent a real and important turn to the upside.

Note that following the 1978 bear rally the bond index turned down and within a matter of 7 weeks the index had plunged

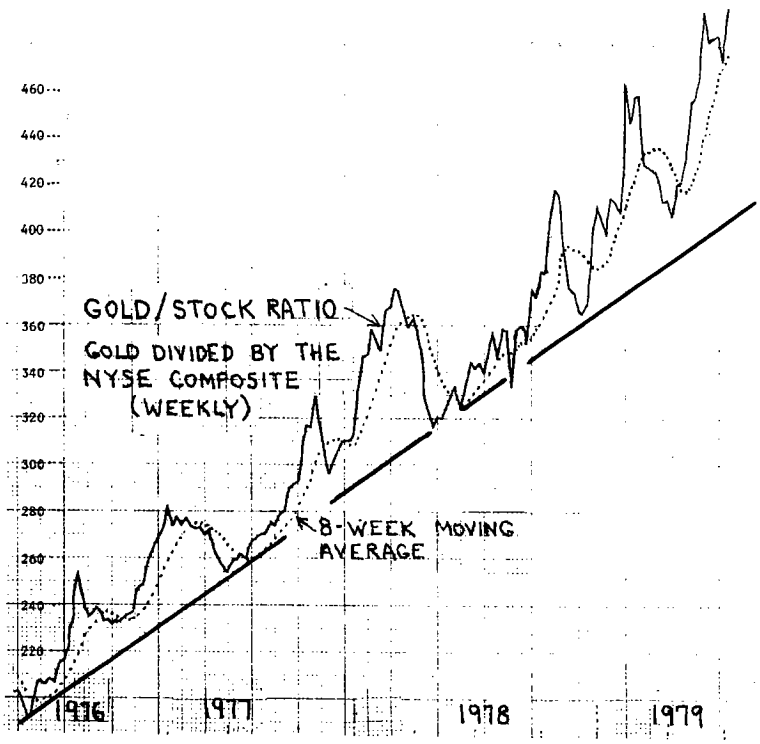


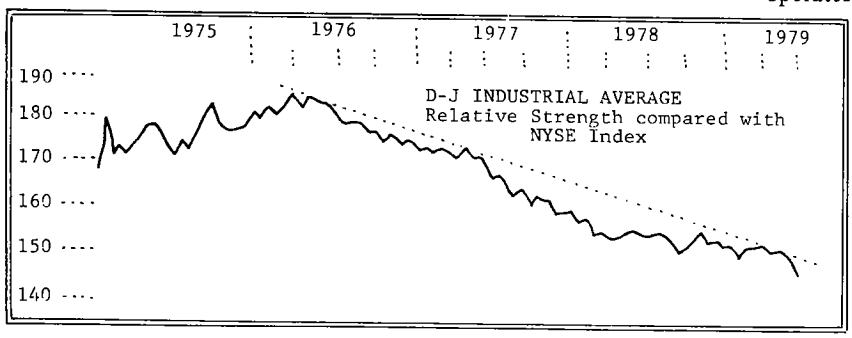
to new lows (without so much as a single week of pause). What the index does this time, following the first peak, will be equally important. If the index backs off but holds above its 1979 low, we will have the makings of an impressive turn. In fact, following the next peak, the smaller the downside correction, the more impressive the action.

Note that in the past when this broad index turned down following a strong rally, the downward action invariably took the index to new lows. This tells me that (1) the first week that produces a downturn in this index would probably represent a good week to take **trading** profits in bonds, and (2) if the next downturn fails to take the index to a new low, we will have probably seen the low for the whole bond market for a long time to come.

TWO IMPORTANT TRENDS: There are two trends that I have been watching with great interest. I've watched these two trends carefully (1) because they are both so fundamental, and (2) because they have both been in force for so long.

The first trend is the ratio of stocks to gold (actually, this is a relative strength ratio). Each week I divide the price of gold by the broad NYSE Index (the index includes all NYSE common stocks). The chart shows the weekly ratio (heavy line) and an 8-week moving average of this ratio. All we can say about the gold/stock ratio is that IT HAS BEEN MOVING UP FOR OVER THREE YEARS! For three years investors preferences have been for gold rather than stocks.





Why would anyone prefer a non-productive (no interest paid) asset like gold to a productive (dividends paid) asset like common stocks? The answer: distrust of money (stocks are denominated in dollars), distrust of the US economic system, distrust of the Government's desire or ability to halt inflation. For whatever reason, the chart tells the story. The gold/stock ratio states unequivocally that GOLD HAS BEEN KING.

The second chart tells an equally fascinating story. On the first and the fifteenth of each month I divide the price of the Dow by the price of the NYSE Index of all common stocks. This shows me investors' preference regarding the Dow or the broad list as exemplified by the NYSE Index. For almost three years the relative strength has been away from the blue chip Dow and towards the broad list. This is an extraordinarily long period for any relative strength trend. I don't think it can last much longer.

So summing up the story told by these two charts we can say that (a) investors have preferred gold to stocks for better than 3 years, and (b) within the universe of stocks, investors have preferred the lower-grade stocks to the blue-chip Dow stocks for over 3 years.

Here are my conclusions: (1) Never fight a trend. You can be skeptical, you can distrust a trend, you can say that the longer a trend is in effect, the nearer you are to the end of that trend–but don't fight the trend. If you do, that trend can send you poor-house bound.

(2) The gold/stock trend (toward gold) is still very much in force, even though that trend is very old. I'm *guessing* that it will reverse, at least temporarily, somewhere ahead (within the next 6 months). When it does stocks are going to outperform gold.

(3) The NYSE/Dow ratio trend is very old. I'm *guessing* that this trend will reverse importantly somewhere ahead (during the next 6 months). When it does the depressed Dow stocks are going to outperform the rest of the market. At that time, money will be made by those who purchase the blue chip, Dow type issues.

The readers should understand in the above discussions that I am not advocating "fighting the trend." I am saying that even though two important trends are still very much in force, they are growing old, and because of this they should be carefully monitored for signs of a turn.

NOTES & QUOTES: I've been reading Vernon Jacobs' monthly "Tax Angles" publication for a few years, and it's excellent. Now he has come out with a little book, "Taxpayers' Counterattack" (Alexandria House, $12.95) and the book is a gem. Every page is chock full of information on taxes and how to pay less of them. Jacobs also knows how the IRS thinks and operates, and he delves into how you can deal with them.

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The mania for getting out of dollars and into collectibles, art, real estate, anything, has reached amazing levels. For instance, two years ago I bought a sheet (50 stamps) of the C18 50-cent Zeppelin stamp for just under $4,000. The sheet would go for around $13,000 today. Two weeks ago a Matisse painting was auctioned off by Sotheby for a record $1.5 million, highest price ever paid for an impressionist painting. I just finished reading "Charmed Circle" about Gertrude Stein and her charmed circle of friends in Paris during the early

1900's. Stein was a good friend of Matisse's. At that time, a Matisse painting could have been purchased for the equivalent of a few hundred dollars.

Why the frenzy to buy "something of value?" Simple: the dollar for decades has been the reserve currency of the world. Throughout the world a person's wealth was measured in dollars. With the acceleration of the dollar's fall, the dollar has become a rudderless ship, and people who measure their wealth in dollars are frightened. Thus the rush to get into "things" of RECOGNIZED value and items that are taxed only once (at the point of sale). In contrast, income from investments are taxed annually.

GOLD: Gold's momentum (13-week rate of change) is leveling off now, and this always presents a good test of strength or weakness. If rate of change simmers down and the *price* of gold holds, that's a bullish sign. If a declining rate of change brings on price weakness, it's usually a sign of a forthcoming correction. On the week ending March 2 gold's momentum hit a high of 128%—which meant that the price was 128% of its price 13 weeks ago. For the week ending July 13 gold's momentum dropped to 120%. If the spot gold price declines below 285, momentum will begin declining in earnest.

The accompanying chart shows daily gold with three moving averages, the 4-week or short term MA, the 13-week or intermediate term MA, and the 50-week or long-term MA. The 4-week MA is now 284, the 13-week is 272 and the 50-week is 237. Thus, if gold holds above roughly 285 all is well, and we simply will be seeing a healthy consolidation. A drop decisively below 285 would turn gold momentum down and it would also penetrate the 4-week MA, something that has not occurred since last April.

European interest rates are rising, even if US rates are not. This together with the usual mindless American budget deficits and inflation is putting new pressure on the dollar. Against this we have the deflationary spector of a world slowdown in trade. All this the buyers and sellers of gold are weighing carefully. Meanwhile, the decline in the US economy will probably hit corporate profits sometime during late-1979 or 1980. This could produce a severe drop in tax receipts to our Government, as well as towering new deficits for the Fed to monetize. Such a fiasco, needless to say, would be bullish for gold and bearish for the dollar.

Progress (if you enjoy super-spending) continues unabated, even at the state level. As a sign of progress, I note that Governor Brown has just presented a 1980 budget of $16 billion for the Golden State of California. To put that amount in perspective, the entire national debt of the US in 1929 was $16 billion. But of course the population was only 120 million at that time. And we must remember that people are a hell of a lot better off today than they were during the savage days of the late 1920's.

"Whom the gods would destroy, they first make mad." And sure enough, the mad spending spree which has characterized the US for the past 40 years has proved the truth of that old adage. Because the dollar, as we know it, has been virtually destroyed. If any further proof is needed, pick up one of those ridiculous new alloy "dollars" which our Treasury has just minted. The coin looks for all the world like a synthetic quarter that has dropped through a garbage disposal. A handful of these absurd new coins is calculated to make any man (or woman) run out and buy Krugerrands. Frankly, if the new metal dollars last four months in circulation I'll be amazed.

LATE NOTES: The Carter speech of speeches was given Sunday night, July 15. My first reaction was "Good, he finally spoke with some real force." My second reaction was, "It's late, awfully late. This speech should have been given the day after Carter took office." My third reaction was, "He never mentioned the inflationary implications of the new spending or the new deficits this program will entail." For the fact is that Carter is talking about an energy war which could cost as much as Vietnam. And finally, I thought of the fighting and the bickerings that are bound to come up as the environmentalists fight the (coal) program tooth and nail, perhaps taking it to the Supreme Court.

But the fact is that there was nothing new or startling in the speech; most of it has been rumored or hinted at before. I'll be fascinated to see how the bond market and the stock market react to the new policy. The critical point in my mind is the 800-820 level on the Dow.

NEXT MAILING: August 1